The Select Committee on Pension Policy

Pension Funding/Accounting Reforms

Public-Sector Impact?

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May 16, 2006

Private-Sector Funding Reforms

- Major reform bill resides in conference committee
- Applies to qualified private-sector plans
- Significant reforms
  - 100% funding target with seven-year amortization
    - One funding rule, one amortization period
  - Liabilities valued at bond rates
  - Asset smoothing periods shortened
  - Increased tax-deductible contributions

Private-Sector Accounting Reforms

- Proposed changes released by the Financial Accounting Standards Board (FASB)
  - Exposure draft and call for comments
- Applies to private-sector employers/plan sponsors
- Changes in response to pressure from SEC and convergence to international accounting standards

Private-Sector Accounting Reforms

- Objective of the changes
  - "Make financial statements … more complete and understandable and, thus, more useful for users …" (FASB)
- Significant changes
  - Over- or under-funded status recognized in the balance sheet
  - Measured as the difference between
    - Fair value of plan assets and fair value of benefit obligation

Emerging Trends

- The main theme is transparency
  - Market-related interest rates (“fair value”)
  - Market-value of assets
    - No smoothing for accounting
    - Shorter smoothing periods for funding
  - Moving away from deferrals, smoothing, longer amortization periods
- Volatility in exchange for short-term focus and increased transparency

Emerging Trends

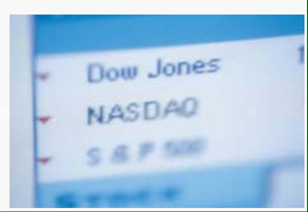
- Where is this coming from?
- What is the application to public-sector pensions?

Current Debate

- The actuarial pension model is contrary to the teachings of financial economics
- The model anticipates expected outcomes without reflecting the price of risk

Finance Principles

- Pension liability measures have nothing to do with how the assets are invested



Example

- Consider a pension plan invested 100% in U.S. Treasuries and fully funded
  - Liability valued at the current Treasury yield rate
- What happens if the fund sells all the Treasuries and replaces them with stocks?
  - Liability revalued using a higher rate for expected return on stocks
  - This lowers the plan's liability
  - Plan would now be "over funded"

Cost of Risk

- Is the plan invested in 100% stocks really over funded?
- Not if you reflect the cost of risk

Cost of Risk

- The fully funded plan invested in 100% U.S. Treasuries has no investment risk of not being able to pay benefits
- The plan invested in 100% stocks has a significant risk of not being able to pay benefits

Potential Consequences

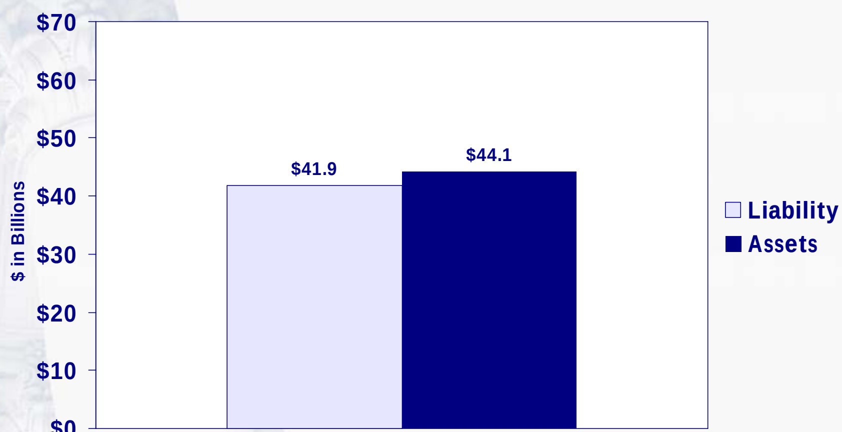
- Strong incentive to take on extra risk to reduce expected long-term costs
- This risk is shifted to future generations
- Can lead to poor financial decisions
  - Pension obligation bonds
  - Increasing benefits based on temporary asset gains
  - Premature reduction of contributions

Impact on Funded Status

- How would plan funded status change if the principles of financial economics (FE) were applied to Washington State?

Funded Status without FE

(at September 30, 2004)

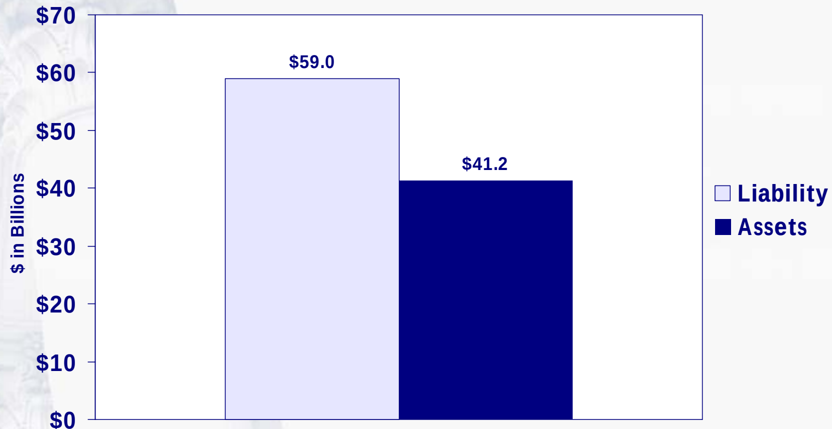


Liability = Credited projected liability valued at 8% interest

Assets = Actuarial or "smoothed" value of assets

Funded Status with FE

(at September 30, 2004)

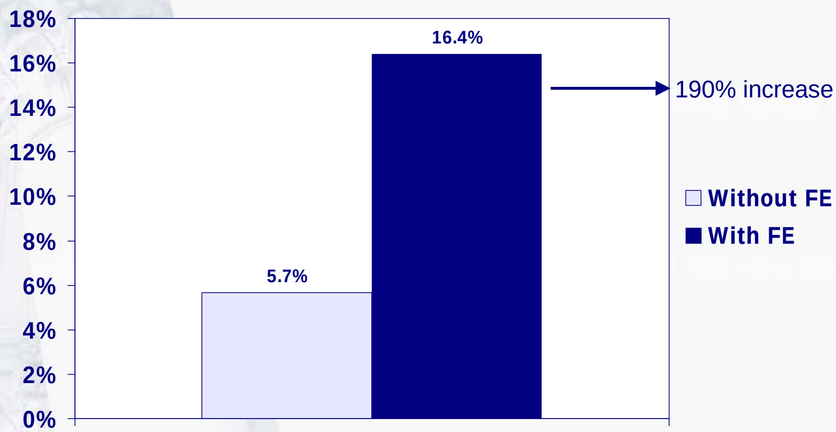


Liability = Credited projected liability valued at 5.5% interest

Assets = Market value of assets

Impact on Contribution Rates

(PERS employer rate)



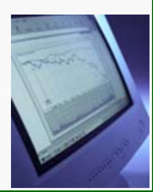
Rates determined from the 9/30/2004 actuarial valuation under the Aggregate funding method. This valuation was not used to determine current contribution rate requirements.

Theory versus Practice

- Can current taxpayers afford the removal of this risk transfer?
- Is this an inappropriate risk transfer?
  - What is the relevance of government being a perpetual entity?
- Contributions would be extremely volatile under current investment allocation
  - Could government budgets adequately respond to the increased volatility?

Application to Public-Sector Pensions

- Application to funding
  - Public-sector plans are ultra long-term investors with contractual obligations
  - Stable and adequate contribution policy minimizes expected long-term cost and spreads risk proportionately
  - Assumptions should be reasonable with a touch of conservatism
  - Actuarial pricing should reflect the cost of risk
    - Show the impact of volatility in returns
    - Informed benefit enhancement decisions



Application to Public-Sector Pensions

- Intergenerational equity
  - Current policy “to fund … benefit increases … over the working lives of those members so that the cost of those benefits are paid by taxpayers who receive the benefit of those members’ service.” (RCW 41.45.010)
  - Principles of financial economics would set the bar even higher
    - No deferral of liability for retroactive benefit increases
    - Immediate recognition of full cost
  - Serves as a solid reminder that the deferral of retroactive benefit increase costs obscures the financial impact

Application to Public-Sector Pensions

- Application to accounting
  - Serves a different purpose than funding
  - Should be understandable and transparent
  - Market values are appropriate and should be disclosed
  - Differences between funding and accounting measures should be disclosed and explained

Conclusion

- Private-sector funding and accounting rules are changing dramatically
- Traditional actuarial pension model does not reflect the cost of risk
- Opportunities for public-sector pensions
  - Secure stable and adequate long-term funding policies
  - Improve intergenerational equity
  - Reflect the cost of risk in actuarial pricing
  - Increase transparency of pension accounting